Chapter 1

Why Study Money, Banking, and Financial Markets?

Financial Markets

- Why Study Financial Markets?
  - channel funds from savers to investors, thereby promoting economic efficiency
  - affect personal wealth and behavior of business firms
- Main Types of Financial Markets:
  - *bond market* – securities are claims on issuer's future income or assets (bonds are debt securities)
  - *stock market* – stocks are shares of ownership, so a claim on the earnings and assets of issuer
  - *foreign exchange market* – trades foreign currencies, the price of which is the foreign exchange rate

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Bond Market
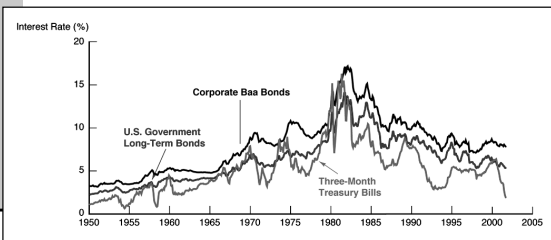

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Stock Market

Dow Jones
Industrial Average
12,000 / 10,000 / 8,000 / 6,000 / 4,000 / 2,000 / 0
1950 1955 1960 1965 1970 1975 1980 1985 1990 1995 2000 2005

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Foreign Exchange Market

Index
(March 1973 = 100)
150 / 135 / 120 / 105 / 90 / 75
1970 1975 1980 1985 1990 1995 2000 2005
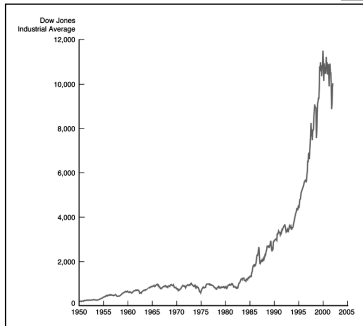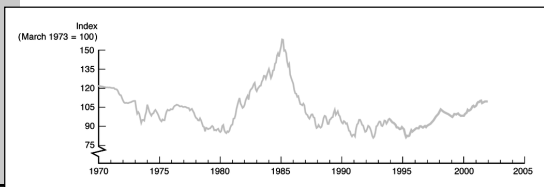
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Why Study Banking and Financial Institutions?

- financial intermediation – helps get funds from savers to investors
- banks and money supply
  - crucial role in creation of money
  - other financial institutions: insurance companies, pension or mutual funds, investment banks, finance companies
- financial innovation – can lead to higher profits and more efficient products (for example, e-finance)

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Why Study Money and Monetary Policy?

- influence on business cycles and inflation (not covered)
- influence on interest rates
  - monetary policy – through central banks (Fed)
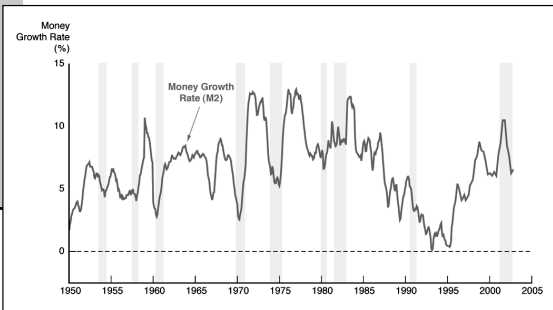 - interaction with fiscal policy

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Money and Business Cycles

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Money and the Price Level
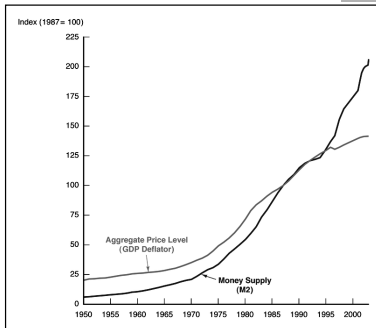
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Money Growth and Inflation
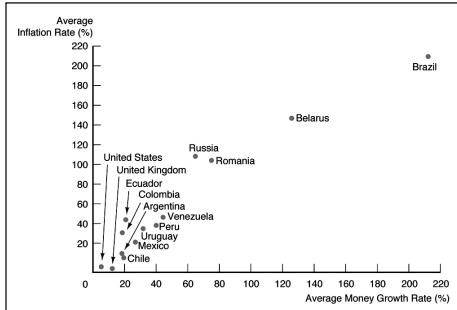
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Money Growth and Interest Rates
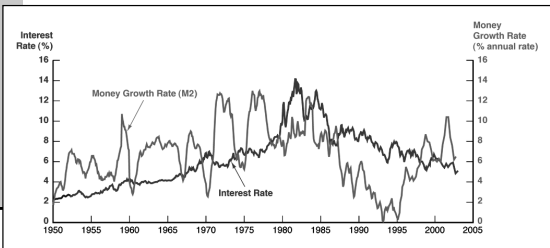
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Fiscal Policy and Monetary Policy
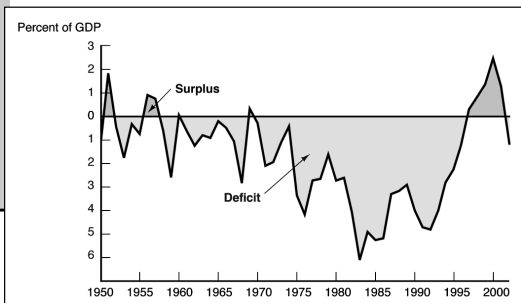
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How We Study Money and Banking

- Basic analytic framework
  - simplified approach to the demand for assets
  - concept of equilibrium
  - basic supply and demand approach to understand behavior in financial markets
  - search for profits
  - transactions cost and asymmetric information approach to financial structure
  - aggregate supply and demand analysis

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Appendix: Definitions

- Aggregate output and income
  - *Gross Domestic Product* (*GDP*) = value of all final goods and services produced in domestic economy during year
  - *Aggregate Income* = total income of factors of production (land, capital, labor) during year
  - distinction between
    - *nominal* = values measured using current prices
    - *real* = quantities, measured with constant prices
- Aggregate price level
  - *GDP Deflator* = nominal GDP / real GDP
  - *Consumer Price Index* (*CPI*) = price of "basket" of goods and services

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Appendix: Definitions (cont.)

- Growth rates
  - calculated as the ratio of change in value to initial value:

  $$\text{Growth rate} = \frac{x_{t+1} - x_t}{x_t}$$

- Inflation rate
  - calculated as growth rate of GDP deflator or of CPI:

  $$\text{Inflation} = \frac{GDPD_{t+1} - GDPD_t}{GDPD_t} \text{ or } \frac{CPI_{t+1} - CPI_t}{CPI_t}$$

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